UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company	Docket No. EL00-95-012
Investigation of Practices of the California Independent System Operator and the California Power Exchange	Docket No. EL00-98-000
California Independent System Operator Corporation	Docket No. RT01-85-000
Investigation of Wholesale Rates	Docket No. EL01-68-000

REQUEST FOR REHEARING OF THE CALIFORNIA ELECTRICITY OVERSIGHT BOARD OF THE APRIL 26, 2001 ORDER

Pursuant to Rule 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713 (2000), and Section 313 of the Federal Power Act, 16 U.S.C. § 8251, the California Electricity Oversight Board (CEOB) hereby requests rehearing of the Commission's April 26, 2001 *Order Establishing Prospective Mitigation and Monitoring Plan for the California Wholesale Electric Markets and Establishing an Investigation of Public Utility Rates in Wholesale Western Energy Markets*, 95 FERC ¶ 61,115 (2001) (April 26 Order). As discussed below, the April 26 Order fails to ensure that wholesale rates are just and reasonable under Sections 205 and 206 of the Federal Power Act, 16 U.S.C. § 824d, 824e, and is arbitrary and capricious, an abuse of discretion and is in excess of statutory authority.

The April 26 Order modifies the Commission's March 9, 2001 *Order Directing Sellers to Provide Refunds of Excess Amounts Charged for Certain Electric Energy Sales During January 2001 or, Alternately, to Provide Further Cost or Other Justification for Such Charges*, 94 FERC ¶ 61,245 (2001) (March 9 Order). The March 9 Order modified the December 15, 2000 *Order Directing Remedies for California Wholesale Electric Markets*, 93 FERC ¶ 61,294 (2000) (December 15 Order) which the Commission adopted after comments on the November 1, 2000 *Order Proposing Remedies for California Wholesale Electric Markets*, 93 FERC ¶ 61,121 (2000) (November 2 Order). The Commission has yet to issue any substantive orders on rehearing in these proceedings. Instead, the Commission chooses to modify previously adopted mitigation measures—once it becomes apparent that they are ineffective and/or impossible to administer—in a series of decisions while requests for rehearing remain pending. Consequently, the State of California has yet to experience any relief from excessive wholesale prices and has been deprived of the right to seek judicial review of the Commission's orders.

I. SPECIFICATION OF ERROR

The April 26 Order is in error in the following respects:

1. The price mitigation mechanism fails to ensure just and reasonable rates as required by the Federal Power act and, therefore, the Commission must institute cost-base ratemaking or otherwise take broad preemptive action to bring rates within the zone of reasonableness within the Western Systems Coordinating Council (WSCC).
2. The proxy price mechanism is based on incorrect cost inputs and will harm consumers by overstating marginal costs.

3. The requirement that the California Independent System Operator (CAISO) and California's Utility Distribution Companies (UDCs) file "an RTO [Regional Transmission Organization] proposal consistent with the characteristics and functions in Order 2000" is arbitrary and capricious, an abuse of discretion and in excess of the Commission's statutory authority. The Commission has no authority to condition the performance of its statutory obligation to ensure just and reasonable rates upon the CAISO's and UDCs' joining or becoming an RTO.
4. The requirement that the CAISO and the UDCs implement demand-side bidding is arbitrary and capricious, an abuse of discretion and in excess of the Commission's statutory authority.
5. The Commission's failure to issue timely substantive orders on rehearing violates the Federal Power Act and is arbitrary and capricious and an abuse of discretion.

II. THE COMMISSION'S PRICE MITIGATION MECHANISM FAILS TO ENSURE JUST AND REASONABLE RATES AS REQUIRED BY THE FEDERAL POWER ACT AND THE COMMISSION MUST TAKE IMMEDIATE ACTION TO ENSURE THAT RATES ARE JUST AND REASONABLE

The Commission has a statutory responsibility under sections 205 and 206 of the Federal Power Act to ensure that wholesale rates are just and reasonable. 16 U.S.C. §§ 824d, 824e. The Commission has recognized that wholesale rates in California have not been just and reasonable[1] and has attempted, in a series of decisions, the most recent of

[1] On November 1, 2000, the Commission Staff issued its Staff Report in this proceedings. Staff found that data "indicate some attempted exercise of market power, if the standard of bidding above marginal costs is used, and some actual market power effects, *to the extent that prices, at least in June [2000] were significantly above competitive levels.*" "Staff Report to the Federal Energy Regulatory Commission on

which is the April 26 Order, to fashion a mitigation measure that will result in just and reasonable rates without returning to cost-based ratemaking or imposing price caps over a broad segment of the market. The Commission's efforts, unfortunately, have resulted in the destruction of one of California's market institutions, the California Power Exchange (CalPX), and have failed to bring prices within a range that can be considered to be just and reasonable. The Commission has no choice but to engage in cost-based ratemaking, or to adopt a sweeping mitigation scheme throughout the WSCC to ensure just and reasonable rates as it is clear that the Commission is unable to insure just and reasonable rates by other means.

A. The Commission's Efforts to Ensure Just And Reasonable Rates Through Incremental Changes To Its Market Mitigation Efforts Have Failed

Since its acknowledgment in the November 1 Order that rates in California have not been just and reasonable, the Commission has imposed a variety of mitigation measures in an effort to address the problem. Rather than impose price caps and/or cost-based rates across the board, the Commission has opted for measures that its believes are more market oriented, i.e. tailored to minimize any disruption to market participants' economic expectations. The Commission has achieved the latter—minimum disruption to participants' economic interests—while utterly failing to achieve the former—market mitigation to ensure just and reasonable rates. The Commission's track record from November 1, 2000 to date has demonstrated the Commission's inability to achieve just and reasonable rates by its chosen means. In fact, it is quite plain that each of the

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Western Markets and the Causes of the Summer 2000 Price Abnormalities - - Part 1, November 1, 2000" at 1-4 (emphasis added). In addition, in its November 1, Order, the Commission found that the "electric market structure and market rules for wholesale sales of electric energy in California were seriously flawed and that these structures and rules, in conjunction with an imbalance of supply and demand in California, have caused, and continue to have the potential to cause unjust and unreasonable rates for short-term energy . . . ." November 1 Order, 93 FERC ¶ 61,239.

Commission's actions has had adverse, perhaps unintended, consequences that have actually made things worse in California.

Moreover, as the Commission has modified its approach through subsequent orders, it has compounded its error by failing to consider the other dramatic changes that have occurred in California. For example, by the time the April 26 Order was issued, there was no factual basis for assuming that the revised mitigation mechanisms would provide the needed relief. This phenomenon illustrates how ill suited the Commission is to deal with complex markets and market institutions in an incremental piecemeal fashion. The Commission is simply too far removed from the realities of the problems in the western United States and too wedded to ideology to see the realities for what they are. Even though cost-based ratemaking is not the sole means of ensuring just and reasonable rates, the Commission is, and always has been, primarily in the business of cost-based ratemaking. This is something the Commission can do that will result in just and reasonable rates. If competition may not be relied upon to ensure just and reasonable rates, the Commission must fall back on what it can do, and what it was created to do, rather than some idealistic hope that this, or the next, incremental mitigation measure will take hold.[2]

1. The November 1 and December 15 Orders

The November 1 and December 15 Orders proposed and adopted, respectively, the Commission's $150 "soft cap" proposal. Under this approach, the maximum market-clearing price in any of the CAISO's or CalPX's energy markets was capped at $150 per MWh. Sellers' bids, however, were not capped. Sellers could bid any amount and be

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[2] The Commission could also implement the CAISO's market stabilization plan and expand it to apply to the WSCC.

paid that amount but only on an as bid basis. Bids above $150 would not set a market-clearing price that all sellers would be paid. Sellers submitting bids above $150 were subject to reporting requirements, including submission of cost data to the Commission staff that would be subject to reasonableness review. Although the CEOB and many other parties had reason to believe that the proposal would not provide effective relief, it must be noted in the Commission's favor, that the remedy was intended to apply broadly. In November 2000, the CIASO's and CalPX's energy markets served 80.7% and 7.4%[3] of California's load. Thus, the vast majority of transactions were subject (at least potentially) to mitigation.

Notwithstanding the Commission's good intentions, the $150 soft cap approach failed to achieve just and reasonable rates for a number of reasons. First, the Commission appears to have assumed that relatively few sellers would in fact bid above the $150 level and that market clearing prices would, for the most part, remain below $150. Since bids above $150 were assumed to be relatively few, the Commission would have adequate staff to review the supporting cost data suppliers would be required to submit in conjunction with such bids. It came as no surprise to the CEOB and the CAISO that this assumption proved to be untrue as many sellers were bidding in excess of $150 before the Commission's December 15 Order.[4] After January 1, 2001, the effective date of the December 15 Order, most bids received by the CAISO were, in fact, in excess of $150 and it became apparent that Commission staff could not adequately (or even minimally) review the sellers' data submissions. (This is borne out by the relatively

[3] Attachment A, Testimony of Patrick K. McAuliffe at 2, f.n. 2.

[4] On December 8, 2000, the CAISO filed a $250 soft-cap proposal because it was not receiving enough bids below the then applicable $250 hard cap.

speedy abandonment of this approach and the adoption of a much narrower approach in the March 9 Order, discussed below.)

Second, the Commission ignored the CalPX's comments filed in response to the November 1 Order and thereafter, that the CalPX could not implement the $150 soft cap approach by January 1, 2001 and would incur excessive costs to implement the approach. Moreover, the CalPX would have little hope of recovering these costs in view of the Commission's directive, also set forth in the December 15 Order, that the UDCs be barred from participating in the CalPX. In fact, the CalPX did not and could not implement the changes and it therefore appeared that there would be no effective price mitigation in the CalPX market.[5]

Third, while it may not have been intended, the December 15 Order resulted in the death of the CalPX. Transactions that might have been consummated through the CalPX would have to be arranged as bilateral out-of-market (OOM) transactions that would not be subject to mitigation even though the Commission has responsibility to ensure that these wholesale prices (at least for jurisdictional utilities) are also just and reasonable.[6] Thus, the November and December Orders failed to afford the level of relief that the Commission intended while having the dramatic consequence of killing the CalPX.

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[5] The Commission ultimately directed the CalPX to recalculate the settlements for January and February 2000 to reflect what the charges and payments would have been under the $150 soft cap proposal. Thus, there may be a price mitigation benefit for transactions in the CalPX for these two months, but no benefit thereafter due to the closure of the CalPX.

[6] For this reason, the CEOB filed a motion in these proceedings requesting that the Commission extend mitigation to transactions outside the CalPX including, in particular, purchases made on behalf of California consumers by the California Department of Water Resources. *See* Motion of the California Electricity Oversight Board for Clarification and Extension of Specific Aspects of the December 15, 2000 Order in Docket Nos. EL00-95-000 et al. filed on March 1, 2001.

2. The March 9 Order

Once the Commission realized that the mitigation approach was both impossible to administer and would not mitigate costs, the Commission issued its March 9 Order which substantially reduced the scope of the mitigation plan. Instead of reviewing cost justification for all bids accepted in excess of $150 in both the CalPX and CAISO markets, as required by the December 15 Order, under the March 9 Order, the Commission would only review prices in the CAISO's real-time imbalance energy market in excess of a monthly proxy price determined by a "rate" formula. In addition, instead of reviewing all hours, the March 9 Order limited review to only hours in which the CAISO had declared to be Stage 3 Emergencies when reserves fall below 1.5%. Thus, the March 9 Order resulted in price mitigation in the CAISO's real-time market only in Stage 3 hours and only if prices exceeded the proxy price, which is calculated pursuant to a formula to represent the most costly resource that might be available during high load Stage 3 Emergency conditions. The proxy price was $273 for January; $430 for February; $300 for March and $318 for April. The deficiencies of this approach were stated succinctly by Commissioner Massey in his dissenting opinion attached to the March 9 Order.

3. The April 26 Order

The Commission, perhaps, recognized that it had gone too far in its March 9 Order by limiting its review only to hours in Stage 3 conditions. The April 26 Order extends mitigation to hours to all emergency conditions (i.e. Stage 1, 2 and 3 conditions)[7]

[7] The April 26 Order retains the use of a proxy price but calculates and implements it differently. The problems with the revised proxy mechanism are discussed below, in Section III.

when reserves fall below 7.5%.[8] April 26 Order at 19. While the Commission may have intended to broaden the scope of its price mitigation mechanism, the CAISO's real-time market has since become practically moribund. In January and February 2001, the CAISO's real-time imbalance energy market served only 4.4% and 4.5% respectively, of total load. Testimony of Patrick K. McAuliffe, Exhibit A at 1 (Exhibit A). By March, the percentage had dropped to 1.4%. *Id*. These amounts compare to November 2000, when CalPX and CAISO energy markets served approximately 88% of total load. Taking one step further, if we look at the hours in the real-time market when the CAISO had called a Stage 1, 2 or 3 emergency for March, for example, the mitigation mechanism as described in the April 26 Order would have only applied to .3% of total MWhs. *Id.* at 2. In contrast, the December 15 Order theoretically applied to the entire 88% of total MWhs, the total amount traded in the CalPX and CAISO energy markets. Thus, the April 26 Order applies to, at most, a miniscule percentage of the market, leaving the vast majority of prices entirely unmitigated.

4. Percentage of energy purchased in short term markets other than the CAISO remains very high

In response to information that the volume of the CAISO's real-time imbalance energy market has been substantially reduced, the Commission might conclude that one of its goals—reducing reliance on spot markets—had been realized. This is not so. Since the CAISO issued its *Order Granting Motion,* 95 FERC ¶ 61,024 (2001) in Docket No. ER01-889-000, which requires a creditworthy purchaser or guarantor for transactions in the CAISO's real-time imbalance energy market, the California Department of Water Resources (CDWR) has stepped in to purchase the UDC's "net short" (difference

[8] The CAISO actually issues Stage 1 Emergency warnings when reserves fall below 7%.

between total supply needed to meet demand and supply owned or controlled by the UDCs) position. CDWR purchases the net-short positions on an extremely short-term basis in large part directly from generators. The net-short purchases must not be confused with the amount of supply clearing in the CAISO's real-time energy imbalance market. The amount of net-short remains extremely high. The CAISO reports that for April and May 2001, the real-time net short—amount of supply needed to meet load that has not been scheduled forward, has been 24%. The CAISO estimates that the net-short will range between 19% and 27% through September 2001 based on a normal load scenario.[9] The CEOB estimates the net-short to be between 30 and 40%. Exhibit A at 2.

CDWR's purchases to meet the UDCs' net short needs are not the kind of long-term contracts that the State of California, also through CDWR, is trying to negotiate. Rather, these purchases are made on a day-to-day basis at extremely high prices—prices that are often well in excess of the CAISO's real-time energy market. The uncompetitive dynamics of California's energy markets—the ability of sellers to command excessive prices—applies to both the CAISO's real-time energy market that CDWR's short-term bilateral purchases. For example, an article published on Monday, April 30, 2001, the Los Angeles Times reported that, during the prior week, the State of California spent $90 million to meet the UDCs' net short needs.[10]

Second, although the April 26 Order extends price mitigation to Stage 1 and 2 conditions, in addition to Stage 3 conditions, the Commission ignores that fact that extremely high prices often prevail during non-emergency conditions. There is ample evidence on the record that prices are unreasonably high even in low load conditions.

[9] These figures are drawn from the CAISO's Motion for Clarification and Request for Rehearing of the April 26 Order filed in these proceedings.

For example, in March—one of the lowest demand months of the year—average real-time imbalance energy price for non-emergency hours was higher than the average prices under Stage 1, 2 or 3 emergency conditions and higher than the $300 proxy price for March. Exhibit A at 3.

Clearly, the Commission's theoretical basis for limiting mitigation to emergency conditions is the assumption that in non-emergency conditions, there is adequate supply to keep prices competitive, i.e. low enough to be considered just and reasonable. Time after time in this proceeding, it has been shown that this assumption does not square with the facts. Prices in California have been unreasonable in most hours and under most conditions and conditions have only gotten worse. Professor Frank Wolak recently estimated that, based on prices in the first two months of 2001, total electricity costs in 2001 could reach ***$70 billion***![11] This compares to estimated costs of $6 billion for 1998 and $7.43 billion for 1999.[12] The Commission must abandon its incremental approach; the market cannot be fixed with twine and bailing wire and ideological hopes. The Commission must extend mitigation to all short-term markets while at the same time eliminating the underscheduling penalty. The underscheduling penalty simply serves to push CDWR to purchase out-of-market in spot market circumstances. Moving transactions out of the CAISO's real-time imbalance energy market only to purchase spot energy out-of-market does nothing to enhance reliability in the way the underscheduling penalty was intended to work.

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[10] CEOB staff confirm the State of California spent $90 million on April 25, 2001.
[11] CAISO's Motion for Clarification and Request for Rehearing of the April 26 Order filed in these proceedings at 29, f.n. 30.
[12] *Id.*

5. The April 26 Order fails to address megawatt laundering and marketer abuse

The April 26 Order fails to remedy megawatt laundering although the Commission acknowledges the existence of the problem. April 26 Order at 11. Megawatt laundering occurs when an export is sold and scheduled from within the CAISO-controlled grid to a point outside the grid and then resold as an import back into the CAISO-controlled grid at a much higher price. In the past, sellers were able to avoid the CAISO's hard price caps by temporarily "parking" energy, by scheduling it as an import, and then and then reselling through the CAISO "out of market" at prices above the price caps.

Under the April 26 Order, imports are still not subject to price mitigation. During hours when the price is mitigated in California, imports can elect to be paid either the proxy market-clearing price or be paid as bid. April 26 Order at 16. Thus, in-state California resources can evade mitigation. Megawatt laundering can only be addressed in the context of a western regional approach that includes cost-based price controls.

In addition, the April 26 Order allows marketers to be paid as bid subject to cost justification. *Id.* at 16-17. The April 26 Order states on page 16 that it "would be exceedingly difficult to try and trace energy back to the generating source to determine its heat rate." Therefore, marketers that do not accept the market-clearing proxy price may justify their bids "based on the prices they paid." Hence, sales to marketers in advance of real time may be a way for generators to get all of their available capacity out of the real-time market where they would be subject to the proxy price. The marketers could then provide the power in real time without a proxy-price test. This loophole allows for the churning of contracts and ever increasing prices that will be deemed by the Commission to be cost justified even though prices may be far in excess of what might be considered just and reasonable under the Federal Power Act. As discussed below, prices must just and reasonable and bear a reasonable relation to the underlying costs subject to recovery in traditional cost-based ratemaking. Accordingly, marketers should not be allowed to justify costs simply on the basis of their purchase price.

B. The Commission's Ability to Depart From Cost Based Rates Is Limited And Costs Must Be Used As A Point Of Departure For Evaluating Whether Market Rates Are Just And Reasonable

The Commission is correct when it observes that the Federal Power Act does not prescribe the manner of determining just and reasonable rates. Nevertheless, cost of service ratemaking is the traditional means by which the Commission has determined whether rates are just and reasonable. The Court of Appeals for the District of Columbia Circuit has held that when the Commission departs from cost-based ratemaking, it must demonstrate that market forces can be relied on to keep prices within a zone of reasonableness. *Farmers Union v. Federal Energy Reg. Comm'n*, 734 F.2d 1486, 1502 (D.C. Cir. 1984). Even the Commission has admitted that market forces have not resulted in just and reasonable rates and total costs. As noted above, California is spending approximately ten times what is spent in 1998 and 1999 for power. For example, the CAISO has calculated that variable costs of production for thermal generation owned by competitive suppliers during December 2000 and January 2001 represent only approximately 58% of their gross revenues. CAISO Report on Real-Time Supply Costs Above Single Price Auction Threshold: December 8, 2000-January 31, 2001 filed in these proceedings on March 1, 2001. The only conclusion that can be drawn is that current wholesale rates are patently unreasonable.

Yet, the Commission has allowed excessive rates to persist while it tinkers with market mitigation measures that have yet to bring prices within the zone of reasonableness. In so doing, the Commission has ignored its primary responsibility to "guard the consumer against excessive rates." *City of Detroit v. Federal Power Comm'n,* 230 F.2d 810, 817 (D.C. Cir. 1956). Indeed, "the Commission has the duty—not the option—to reform rates that by virtue of changed circumstances are no longer just and reasonable." *Louisiana Public Service Comm'n v. Federal Energy Reg. Comm'n,* 184 F.3d 892, 897 (D.C. Cir. 1999). And the Commission must compare prices against costs to assess the reasonableness of non-traditional rates.

The Court explains how the reasonableness of rates must be measured against costs:

> For, though we hold that [the cost-based ratemaking] method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful-- 'just and reasonable'-- rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning.

Id. at 818-19.

The Commission has justified excessively high prices in order to increase supply over the longer term. Under the Federal Power Act there is no justification for costs that are in excess of the zone of reasonableness. The Court of Appeals teaches that economic considerations may justify a rate higher than the rate that would result from traditional ratemaking.

> if, in a balancing of investor and consumer interests, they are brought by evidence and findings into rational relationship to what is 'just and reasonable.' See *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. at pages 603, 615, 64 S.Ct. at pages 288, 294. And in considering whether the two interests are properly balanced *we must keep in mind the basic purpose of the statute to protect consumers from excessive rates*, ...

City of Detroit, 230 F.2d at 816 (emphasis added). The Commission has bent over backwards to favor investor interests over consumer interests without any balancing whatsoever. Moreover, excessive prices are not needed to attract new supply. High prices in spot markets simply attract existing supplies to those markets. Since supplies are short throughout the west, prices simply rise everywhere without increasing existing capacity. Investors in new power plants, on the other hand, must base their businesses decisions on the long term forecasts especially in a capital intensive industry like the electricity industry that has a lengthy siting process (even if streamlined).

Nor can the Commission insist that before it can order refunds or changes to an existing rate schedule that an aggrieved party must prove that the seller in question has exercised market power.[13] Under the Federal Power Act, the Commission must adjust rates whenever they are found not to be just and reasonable regardless of the reason.

III. THE PROXY PRICE MECHANISM IS BASED ON INCORRECT COST INPUTS AND WILL HARM CONSUMERS BY OVERSTATING MARGINAL COSTS

As detailed above, the purported protection offered by the Commission’s plan to mitigate wholesale prices through a market clearing proxy price is wholly illusory. The quantity of transactions in the CAISO real-time market has dwindled to such an inconsequential level that there is virtually no market remaining to mitigate. Moreover, any protection to California consumers will be further eroded by use of a proxy price formula that overstates marginal costs. The complexity, variability, and uncertainty of the natural gas and emission credit regimes in California prevent creation of surrogate measures that accurately reflect generator costs and, therefore, support reliance on a cost-based mitigation scheme.

First, and foremost, the Commission must abandon the use of published indexes of reported transactions as a basis for imputing costs. Indexes of this sort can be manipulated easily by market participants by entering into and reporting transactions that can raise the published index without significantly raising generators' own costs.[14]

Assuming the Commission refuses to abandon the ineffectual market clearing proxy price methodology, the Commission should (1) modify the gas input to more closely approximate generators' true marginal fuel costs and (2) exclude NOx emission costs from the proxy price altogether, but allow those costs to be recovered upon justification per generator if appropriate.

A. The Commission's Use of Daily Spot Gas Prices Will Overstate Fuel Inputs

The April 26 Order proposes to use a gas cost proxy based on "an average of the daily prices published in the Gas Daily for all California delivery points."[15] April 26 Order at 15. The Commission's reliance on the daily spot prices conflicts with the central goal of mitigation – to ensure just and reasonable prices. On May 18, 2001, the Commission issued its *Order Proposing Reporting Requirement On Natural Gas Sales To California Market And Requesting Comments,* Docket No. RM01-9-000 (May 18

[13] There is, of course, abundant non-controverted evidence on the record that market power has been exercised—suppliers have profitably raised prices.
[14] Testimony of David Vidaver, submitted as Exhibit 2 to the Motion of the California Air Resources Board for Immediate Limited Rehearing and Clarification or, in the Alternative, Immediate Partial Stay and Technical Conference, Docket No. EL00-95-012 et al., May 24, 2001 ("ARB Motion").

Order). In that order, the Commission acknowledged the dramatic disparity in daily gas spot prices between California and other markets.

> As reported in the May 18, 2001 Gas Daily, the most recent daily spot price for gas various points on the southern California border are in excess of $9.00, while in the producing basins and other downstream markets, the spot prices are in the $4 range. For example, the spot price for SoCal Gas, large packages was $9.60-11.00, while for El Paso Permian Basin area it was $3.80-4.08, and for Transco, New York citygate it was $4.50-4.68. [May 18 Order at 2.]

The purpose of the May 18 Order was to gather information to determine what action, if any, must be done to correct the perceived dysfunction in the California gas market. The Commission is further investigating the possible exercise of market power in the California gas market. *Public Utilities Commission of the State of California v. El Paso Natural Gas Company, et al.*, 94 FERC ¶ 61,338 (2001). Whether or not the California gas market is sufficiently competitive to produce just and reasonable prices remains uncertain and under investigation. Until and unless the Commission can properly conclude, based on substantial evidence, that the gas market itself is competitive, the Commission's knowing reliance on a facially deviant market is unreasonable.

The Commission's reliance on daily spot gas prices is further flawed for the basic reason that it fails to approximate the marginal cost to electricity producers. The formula assumes that the natural gas used to generate electricity is purchased on the spot market. The Commission admitted it has no evidence to corroborate this assumption: "At present, the Commission does not have reliable information concerning the percentage of gas

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[15] The CEOB assumes that the Commission's reference to "California delivery points" refers to Malin, the

moving into the California market that is actually priced at the high spot market prices reported at the California boarders." May 18 Order at 4.

The assumption that generators purchase 100% of their natural gas needs is certainly inaccurate. Each of the five largest gas-fired generators in California has natural gas affiliates. These companies are permitted to utilize their affiliates to hedge fuel price risk. As such, the cost of gas supply for generators reflects a portfolio encompassing spot, short-term and long-term purchases. The Commission also recognized the inaccuracy of assuming all natural gas purchases were made at the high spot California border prices. "While the spot market prices for gas at the California border have been relatively high, gas purchasers holding firm capacity on interstate pipelines can purchase natural gas at the spot market prices available in producing basins, and then have the gas transported to California markets over their firm capacity." *Id*. Thus, it is unreasonable for the Commission to sanction a methodology that results in inflated bids exceeding the generators' true costs.

B. Assuming The Commission Proceeds With Implementation Of The Proxy Price Mechanism, The Commission Should Utilize Forward Gas Prices.

Rather than using the average of the daily natural gas prices as described in the Commission's April 26 Order, the weekly (or monthly) gas price at each natural gas hub (Malin, PG&E Citygate, and Southern California border) should be used.[16] This specific

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Southern California Boarder and PG&E Citygate.

[16] The use of a single average for the daily prices for all California delivery points would result in an indefensible windfall to generators. The problem lies in the fact that a wide degree of variation exists among the individual points. The prices posted per million Btu for the three regularly reported California delivery points were far apart on May 16 were: (1) Malin - $4.835; (2) PG&E Citygate - $6.150; and (3) SoCal Border -$10.575.

The average of those three numbers is $7.187 per million Btu. Accordingly, proxy bids for generating units in the far north would be much higher than their actual marginal costs. Generating units in the South, while failing to be fully compensated under the proxy price, would simply elect to submit an individual bid based price should be ascribed to each generating station based on location. That is, stations served by the Malin connection should have their proxy priced based on the Malin index, while generating stations served by the other gas lines should have those specific gas prices used in the calculation of that station's proxy price. In addition, the clearing price in California should not necessarily be uniform but rather each of the three regions served by different pipelines (even though there is some interconnection among these pipelines) should have a different clearing price, depending upon the last unit dispatched in that region.

Such a method has two clear advantages: (1) by using a longer time index that a daily spot price, we will encourage generators to buy a large portion of their expected natural gas needs in a forward market; and (2) zonal clearing prices more accurately reflect the electrical transmission constraints in California.

C. The Commission's Proposed NOx Emission Cost Proxy Fails To Reflect Reality And Must Disregarded

The April 26 Order requires that the CAISO calculate the proxy price by including emission costs based on data from the Cantor Fitzgerald Environmental Brokerage Services ("Cantor") and the emission rate for the unit. April 26 Order at 15. Recently, the California Air Resources Board[17] ("ARB") and the South Coast Air Quality Management District[18] ("SCAQMD") detailed the regulatory scheme governing air quality in California, and more specifically, the use of emission credits in the SCAQMD

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on its higher costs. Thus, the simple average would raise overall costs in the North and be irrelevant to calculating prices in the South.

[17] Motion of the California Air Resources Board for Immediate Limited Rehearing and Clarification or, in the Alternative, Immediate Partial Stay and Technical Conference, Docket No. EL00-95-012 et al., May 24, 2001 ("ARB Motion").

[18] Letter from Barry Wallerstein, Executive Director of the SCAQMD, to Daniel Larcamp, Director, Office of Markets, Tariffs & Rates, Federal Energy Regulatory Commission, dated May 16, 2001.

and throughout the State.[19] The CEOB will not duplicate the information provided by those organizations, but rather respectfully refers the Commission to those submissions. The CEOB, however, echoes the conclusion reached by the ARB that use of the Cantor data would be arbitrary and capricious and would unreasonably inflate the proxy market-clearing price. Furthermore, the impracticality of establishing an emission cost input that ensures a just and reasonable proxy price requires that the Commission engage in cost-based ratemaking.

To begin, the April 26 Order is ambiguous as to the meaning of "emission costs" related to NOx output. For NOx emissions, Cantor reports both "emission reduction credits" ("ERC") and "Reclaim Trading Credits" ("RTC"). As explained in the ARB's motion, ERCs are issued to a facility at the time of permitting to offset its emissions and the quantity of ERCs issued and the cost varies significantly among air districts depending on the degree of "nonattainment" of air quality standards in the issuing air district. Also, given that ERCs are procured prior to operation and are dedicated for the life of the project, ERCs actually constitute fixed, not variable costs, and are irrelevant to the marginal cost of operation and the underlying rationale of the April 26 Order.

RTC costs reported in Cantor also form an unreasonable measure of variable emission costs for several reasons. First, RTCs issued pursuant to the SCAQMD's RECLAIM program apply to only 20% of California's generating capacity. Second, RTCs are needed only if the generator exceeds its annual baseline credits assigned without cost. As such, uniformly applying RTC costs in the proxy price assumes,

[19] The Commission has long been in possession of information in this docket demonstrating that reliance on NOx emissions credits associated with the SCAQMD's Regional Clean Air Incentives ("RECLAIM") program to determine a proxy price is improper. See, e.g., Testimony of Michael H. Scheible, Deputy Executive Director of the ARB, Attachment to Comments of the California Public Utilities Commission,

without any foundation, that each facility has exceeded its baseline allocations. Third, and most importantly, the RTC market reported by Cantor no longer exists with respect to electric generators. As explained in the ARB's filings, as of February 6, 2001, pursuant to rules promulgated by the SCAQMD, generators no longer purchase RTCs. Instead, generators that consume their baseline emission allocations and exceed their emission limitations pay a mitigation fee of $7.50 per pound.

Clearly, continued reliance on Cantor by the Commission would be arbitrary under the circumstances. More importantly, it would be inappropriate for the Commission to simply substitute the $7.50 administrative fee into the proxy formula. As discussed by the ARB, Governor Davis, pursuant to executive order, has authorized existing electrical generation facilities to operate in excess of allowed hours of operation to maximize available capacity upon payment of a mitigation fee. The exact fee charged, and the conditions under which it will be triggered, are the subject of negotiation between the particular air district and generator. Such terms will vary widely among the 35 California air districts, and within each district, depending upon the generators' original allocation of ERCs and efficiency characteristics as well as the local air quality conditions.

Consequently, each generator to the extent it is even subject to a mitigation fee agreement will have highly idiosyncratic emission costs. Any attempt by the Commission to establish a proxy price will, therefore, inevitably lead to overstating a

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Docket No. EL00-95-000 (Nov. 22, 2000); Application for Rehearing of the California Independent System Operator Corporation, Docket No. EL00-95-017 (April 9, 2001).

generators' variable cost and further push wholesale prices beyond the zone of reasonableness.[20]

IV. THE COMMISSION'S ATTEMPT TO IMPOSE A CONDITION ON ITS PERFOMANCE OF ITS STATUTORY OBLIGATION TO ENSURE JUST AND REASONABLE RATES IS UNLAWFUL

The April 26 Order conditions implementation of all proposed mitigation measures on the CAISO and the three investor owned utilities filing an RTO proposal by June 1, 2001. April 26 Order at 2, 28. The condition is legally untenable on several grounds. First, similar to the decision to confine price mitigation to real-time transactions only during reserve emergencies, the condition signals abandonment by the Commission of its statutory mandate to ensure just and reasonable prices. Second, imposition of the condition is arbitrary and capricious. As Commissioner Massey recognized, "[t]he California ISO and the three utilities must make an RTO filing, but this has no relevance to price mitigation over the next year." *Id.* at 4 (Massey dissenting). Third, to the extent the Commission intends to force California into joining an RTO, the condition exceeds the Commission's authority. Simply put, the Commission cannot do indirectly through intimidation that which it cannot do directly under its regulatory authority.[21]

A. The Condition Constitutes Abdication Of The Commission's Statutory Duty Through An Unlawful Delegation Of Regulatory Power To Private Entities

[20] It should be noted that inclusion of emission costs in the proxy price will exacerbate the burden on California by increasing the cost of imports. Under the April 26 Order, an out-of-state generator, not subject to emission costs, will be permitted to bid at the proxy price. To the extent the Commission persists in implementing a proxy price, a formula that does not include emission costs will more accurately capture the cost of out-of-state resources.

[21] The Commission can condition actions it takes in certain circumstances, upon an applicant accepting a particular condition or set of conditions. This occurs in merger cases and applications for market-based rates, and proposed ISO or RTO applications. In these cases, the applicants filed voluntary petitions to receive the necessary approvals. However, the Commission cannot require entities to make such filings in the first place or to condition its own performance of its statutory duty upon such a filing.

The Federal Power Act ("FPA") compels the Commission to ensure that rates are just and reasonable. 16 U.S.C. § 824d(a). Indeed, a condition precedent to the Commission's exercise of power under section 206(a) is a finding that an existing rate is unjust, unreasonable or unduly preferential and discriminatory. *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. 348, 353 (1956). The April 26 Order necessarily embodies such a finding for at least a portion of the California electric wholesale market. Nevertheless, as noted by Commissioner Massey in dissent, "if the California ISO and the three investor-owned utilities fail to make an RTO filing by June 1, the entire order turns into a pumpkin and is of no effect. … this order becomes null and void." April 26 Order at 4 (Massey dissenting).

The Commission cannot impose the RTO condition as justification for abdicating its statutory duty toward California consumers. Administrative agencies do not possess the discretion to avoid discharging the duties that Congress directed them to perform. *See Public Citizen Health Research Group v. Commissioner, Fed. Drug Admin.,* 740 F.2d 21,32 (D.C. Cir. 1984); *Gillis v. United States Dept. of Health and Human Servs.,* 759 F. 565, 578 (6th Cir. 1985). Accordingly, "[a]s to matters within its jurisdiction, the Commission has the duty – not the option – to reform rates that by virtue of changed circumstances are no longer just and reasonable." *Louisiana Public Service Comm'n v. Federal Energy Reg. Comm'n,* 184 F.3d 892, 897 (D.C. Cir. 1999).

B. The RTO Condition Has No Relation To Immediate Price Mitigation And Therefore Is An Abuse Of Discretion.

Agency actions must be set aside if arbitrary and capricious. 5 U.S.C. § 706(2)(a). An action is arbitrary and capricious if the agency fails to provide an adequate explanation for its actions, and the explanation fails to show a "rational connection between the facts found and the choice made." *Motor Vehicle Mfrs. Ass'n of the United States v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). Based on this standard, the Commission's decision to condition price mitigation on the RTO filing cannot survive.

The Commission's limits price mitigation for one year from the effective date of the April 26 Order. April 26 Order at 25.[22] As Commissioner Massey stated in his dissent, the RTO regulatory filing "has no relevance to price mitigation over the next year." April 26 Order at 4 (Massey dissenting). The purported justification for imposing such a truncated period was wholly unconnected with the status of any efforts by California entities to form an RTO.

> During the period of a year, many aspects of the California market are likely to change, including the introduction of significant new generation. For example, Governor Davis' press release April 4, 2001 cites to the California Energy Commission's current status report indicating that new generation totaling 4,168 MW will be on line by the end of August 2001 and there could be as much as 6,879 MW on line for the summer of 2002. In addition, within a year, the requirements of this order requiring greater demand response will be effective.

Id. A potential RTO involving California cannot possibly have any effect on increasing supply or demand responsiveness during the mitigation period. The total absence of any logical nexus between the proposed price mitigation and the RTO condition evidences a manifest lack of good faith on the part of the Commission. Indeed, rather than focus on increasing the efficacy of its proposed remedial measures, the Commission appears intent on waging a jurisdictional war through coercion and intimidation of state authorities. The RTO condition, therefore, is arbitrary and capricious and must be rescinded by the Commission.

C. The Commission Does Not Possess The Statutory Authority To Force California Entities To Participate In An RTO

The CAISO and the three California public utilities must make an RTO filing. 18 C.F.R. §§ 35.34(c), (d) and (g). That filing can either involve a proposal to participate in an RTO or explain why obstacles exist to such participation. *Id*. As discussed above, the Commission's attempt to condition implementation of price mitigation on the very submission of an RTO filing is inappropriate. Moreover, to the extent the April 26 Order is intended to require the California entities to propose an RTO, or a particular form of RTO, the Commission has acted in excess of, and contrary to, its statutory authority. See 5 U.S.C. § 706(2)(a).

In Order 2000, the Commission expressly adopted a "voluntary approach to participation in RTOs." Order 2000, 89 FERC ¶ 61,285 (1999) at p. 117. The Commission embraced a voluntary approach, in part, specifically to avoid a "challenge to [its] legal authority to mandate RTO participation." *Id.* at 116.[23] The Commission further elected "not to limit the flexibility of proposed structures or forms of organization for

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[22] The CEOB also takes issue with this condition as well. The Commission is obligated to ensure just and reasonable rates at all times. It is an abuse of discretion and arbitrary and capricious to eliminate price relief upon a date certain without consideration of whether rates are, in fact, just and reasonable.

RTOs." *Id.* at 124. Nor did the Commission prescribe the geographical or regional scope of any RTO. Rather, the Commission was "convinced that the transmission owners, market participants, and regulators in a particular region have a better understanding of the dynamics of the transmission system in that region, and that they should, at least in the first instance, propose the appropriate scope and regional configuration of an RTO." *Id.* at 126. By delegating to the local entities initial control over the regional scope of any RTO, the Commission explicitly acknowledged "the interests of individual states regarding RTO boundaries." *Id.* at 128

The Commission cannot, as it has attempted to do here, deviate in an *ad hoc* manner from Rule 2000. "For [an] agency to reverse its position in the face of a precedent it has not persuasively distinguished is quintessentially arbitrary and capricious." *Louisiana Public Service Comm'n v. Federal Energy Regulatory Comm'n*, 184 F.3d 892, 897 (D.C. Cir. 1999). Moreover, Rule 2000 possesses the force and effect of a federal statute and cannot be modified without compliance with the rulemaking provisions of the Administrative Procedures Act. Thus, to the extent the Commission contemplated imposing any additional requirement on the California entities other than strict compliance with the generic RTO filing provisions under 18 C.F.R. § 35.34(c), the RTO filing condition in the April 26 Order is in excess of the Commission's statutory authority.

[23] Indeed, to the extent the April 26 Order was intended by the Commission to prescribe the substance of the RTO filing, the Commission's decision to do so indirectly through a condition, rather than directly by order, implicitly acknowledges the limits of the Commission's jurisdiction in this area.

V. THE COMMISSION'S DEMAND-SIDE BIDDING REQUIRMENT IS INCONSISTENT WITH THE FPA AND IS ARBITRARY AND CAPRICIOUS

The April 26 Order requires public utilities—including the UDCs—to submit demand-side bids indicating the price at which load will be curtailed and identifying the specific load. As written, it is by no means clear how the Commission intends for this requirement to be implemented. The most obvious literal interpretation would require: (1) real-time pricing for retail customers; (2) for all retail load to state a maximum purchase price; (3) load to be curtailed when the price reaches the maximum. If this is the Commission's intention, it has taken a step well beyond its statutory authority. Retail rates matters are within the state's exclusive jurisdiction. In addition, merits of the proposal aside, nothing like this could be implemented any time soon as it would require universal deployment of real-time metering, two-way communication and control devices, among other things.[24]

The Commission may intend something less involved, perhaps to require the UDCs to name their top price and then to simply drop load on a rotating basis. This interpretation also impermissibly intrudes upon state jurisdiction over retail matters. Such an interpretation also conflicts with the Commission's *Order Granting Motion*, 95 FERC ¶ 61,024 (2001) in Docket No. ER01-889 which prohibits the UDCs—since they no longer satisfy the CAISO's creditworthy requirements—from scheduling any demand or supply in excess of amounts matching supply they own or control through contracts. Accordingly, pursuant to the Order Granting Motion, UDCs would not be able to submit

[24] Nonetheless, California is diligently working on demand side programs that can be in place in the foreseeable future and is looking into real-time pricing proposal for the future.

demand bids. Moreover, the CDWR is the entity currently responsible for purchasing the net short needs of the UDCs and is not a public utility and is not a load-serving entity.[25]

VI. THE COMMISSION'S FAILURE TO ISSUE TIMELY SUBSTANTIVE ORDERS ON REHEARING VIOLATES THE FEDERAL POWER ACT

Section 313(b) of the Federal Power Act allows parties to seek judicial review in the Court of Appeals within 60 days from the date of a decision on rehearing. A decision on rehearing is, thus, a prerequisite for the filing a petition for judicial review in the Court of Appeals. 16 U.S.C. 825l(b). Section 313(a) provides that a party must file a request for rehearing with the Commission within 30 days of an order. 16 U.S.C. § 825l(b). Section 313(a) further provides that, "unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied." 16 U.S.C. § 825l. Accordingly, if the Commission fails to issue a decision on rehearing, the Commission cannot, indefinitely, deprive an aggrieved party of the right to seek judicial review. Section 313 is a clear statement of Congressional intent to allow for prompt judicial review of final Commission decisions.

Notwithstanding the congressional intent to allow for prompt judicial review, the Commission routinely issued non-substantive orders on rehearing to allow the

[25] The April 26 Order also requires the CAISO to prepare and file proposed outage coordination tariff language. In imposing this requirement, the Commission may also be in excess of its statutory authority. Section 201(b)(1) of the Federal Power Act provides that the Commission "shall not have jurisdiction, . . . over facilities used for the generation of electric energy . . . ." 16 U.S.C. § 824b(1). The State of California certainly maintains that it has jurisdiction to regulate the generation facilities within the State of California in the area of outage control. In fact, the CAISO has begun the process of implementing D-23-01, Governor Davis' Executive Order, which requires the CAISO and the EOB to develop and implement outage protocols. As stated in its May 11, 2001 comments filed in these dockets in response to the CAISO's filing of proposed tariff language, the CEOB believes that the CAISO's proposed tariff language is consistent with Governor's mandate and the April 26 Order. For this reason, the CEOB found the proposed tariff language to be acceptable. However, as CAISO noted in its proposed tariff filing, California may enact legislation in the area of outage coordination that may require the CAISO to revised its tariff in the future.

Commission additional time to issue a substantive order. These so called "tolling orders" can effectively delay judicial review indefinitely. In these proceedings, the Commission has issued tolling orders for the November 1 Order, the December 15 Order and the March 9 Orders. It, thus, appears that the Commission elected to issue orders in a series rather than issue orders on rehearing.

VII. CONCLUSION

For the reasons discussed above, the CEOB respectfully requests that the Commission issue an order on rehearing that takes the following actions:

1. Ensure just and reasonable rates by implementing a comprehensive and effective western-regional mitigation approach that eliminates megawatt laundering and closes loopholes available to marketers, or by imposing cost-based rates.
2. Extend price mitigation to all purchases in the CAISO's real-time imbalance energy market, not just purchases in emergency conditions, and extend price mitigation to all short-term purchases, and eliminate the underscheduling penalty.

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3. Impose price mitigation on all jurisdictional sellers within the WSCC.

4. If the Commission retains a proxy price mitigation mechanism, exclude pollution emissions costs entirely and impute gas costs based on longer-term averages separately determined for the geographical location of the resources.

5. Eliminate the RTO filing requirement as a condition for imposing price mitigation and eliminate the one-year limitation and full the statutory obligation of ensuring just and reasonable rates at all times.

6. Remove the Demand bidding aspects of the April 26 Order.

Dated: May 25, 2001

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served upon each person designated on the official service lists compiled by the Secretary for these proceeding on or before May 29, 2001, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure.

Dated at Sacramento, California, this 25th day of May, 2001.

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